

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Poochigian/Johnson Analyst: Marion Mann DeJong Bill Number: SB 831
Related Bills: See Legislative History Telephone: 845-6979 Amended Date: 03/27/2001
Attorney: Patrick Kusiak Sponsor: California Senior Legislature

SUBJECT: Allow Taxpayers with Income Less than Specified Amount to Use 540 2EZ

SUMMARY

This bill would require FTB to provide qualifying taxpayers with the option of using a specific tax form to report and file their income tax.

PURPOSE OF THE BILL

The purpose of this bill is to make it easier for taxpayers, including seniors, to file their income tax returns.

EFFECTIVE/OPERATIVE DATE

This bill would be effective and operative on January 1, 2002.

POSITION

Pending.

Summary of Suggested Amendments

Amendments are needed to resolve the issues discussed under "Implementation Considerations." Department staff is available to work with the author to resolve these issues.

PROGRAM BACKGROUND

Individuals generally start their income tax preparation by completing the federal income tax return. They first determine their federal gross income, which includes the items listed in this bill as "total income," plus many other income items. Adjustments (subtractions and additions) are then made to gross income to compute federal adjusted gross income (AGI).

The department provides a variety of tax forms (including instructions and schedules) for personal income tax (PIT) taxpayers. Tax forms are designed to enable taxpayers to self-assess their correct tax liability. The instruction booklets generally include worksheets and tax tables to aid the taxpayer in making the calculations necessary to compute the correct tax liability. The tax forms generally reflect any income that is taxable under federal law but not California law, so the department can capture that data for statistical purposes. Information on the various income tax return forms is provided below.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Gerald H. Goldberg

04/12/01

The form that a taxpayer should use is determined by several factors, including filing status, dependents, amount and sources of income and deductions. The department has created forms to fit general demographic categories of taxpayers based on the income and deductions they are most likely to have. The forms range from the most complex, which accommodate any combination of income and deductions, to the simplest, which accommodate income profiles made up of only wages, a small amount of interest income and no deductions. Each of these categories serves a large group of taxpayers and the differences between each form is easy to communicate to taxpayers.

Form 540 -- The longest income tax return form. All taxpayers may file this form. This form is designed to recognize all income items and modifications that a taxpayer may be required to include in computing the correct tax liability. Ultimately, the department is responsible for determining that the correct tax liability is shown on the taxpayer's income tax return. For this purpose, the department requires taxpayers with certain income items to attach a copy of the federal return and federal schedules to the California income tax return. Through the copy of the federal income tax return and schedules, the department can verify the correctness of the taxpayer's income items and calculations. The Form 540 is two pages long with 70 lines of data.

Form 540A -- A less complex income tax return form. The Form 540A is two pages with 40 data lines. In general, taxpayers with the most common income items and deductions can use this form. These taxpayers may have limited modifications to federal AGI and deductions to reflect state and federal differences, and may claim limited credits. The income limitations were removed from this form for 2000 to allow more taxpayers, specifically seniors, to use the form.

Form 540A Senior -- A newly published special edition for seniors and a less complex form (tax year 2000). Instructions are in larger print and focus on those items commonly of interest to seniors. The instructions highlight the higher senior income thresholds and the senior exemption credit. The income tax return form itself is the same as the other Form 540A.

Form 540 2EZ -- The least complex form. It is a newly designed two-page post-card size income tax return (tax year 1999). This income tax return was designed separate and apart from the federal income tax return; the taxpayer does not copy figures from the federal return. Previously, the least complex form was the Form 540EZ, but with the creation of the Form 540 2EZ and revisions to the Form 540A, the Form 540EZ was discontinued in 2000. The Form 540 2EZ was designed based on the 540 EZ. It is restricted to those taxpayers with the least complex income items, who use the standard deduction, who have no more than three personal exemption credits, and whose only tax payments are in the form of wage withholding. The Form 540 2EZ taxpayers must use a special tax table. Built into this table is the standard deduction and up to three personal exemption credits. Approximately 3 million taxpayers are eligible to use this form.

Form 540NR -- A form designed especially for part-year residents and nonresidents. This form recognizes the unique tax calculations required of these taxpayers.

Tax return filing -- Paper forms must be mailed to FTB. However, technology allows California taxpayers many alternatives to paper filing that allow faster, easier, and more accurate filing. For example, Internet filing, electronic filing, Telefile, and a variety of scanning options.

ANALYSIS

FEDERAL/STATE LAW

The state income tax law for all individuals is largely patterned upon the federal income tax law. Current state income tax law requires the department to make the tax forms as simple as possible for taxpayers to prepare. The department is required to design the forms so taxpayers can copy figures from or attach a copy of their federal returns. The following are items that must be taken into consideration in tax form design and tax return preparation:

Adjusted gross income (AGI) -- Individuals generally begin their California PIT return preparation by copying their federal AGI to their California income tax return. Additionally, other federal income tax return numbers are copied to the California income tax return. However, frequently federal and state differences require that the taxpayer modify an income item(s) reflected in the federal AGI for California income tax purposes to determine California AGI. The source of income dictates the complexities of the modifications. The following include some of the income items that may be subject to different treatment under federal and state law and, therefore, are subject to modifications for California tax purposes:

- mutual fund dividends;
- social security benefits;
- capital gains/losses;
- retirement-type distributions;
- constitutionally exempt interest income;
- lottery winnings;
- depreciation; and
- disaster or net operating losses.

Filing requirements -- Federal and state income tax law requires individuals to file a tax return when their AGI reaches certain dollar levels (AGI threshold). For California, the thresholds are increased for seniors or individuals with dependents. Generally, married individuals file their state income tax return with the same filing status as used on their federal income tax return, either married filing separately or married filing jointly.

Credits -- Once the tax amount is computed, the individual may be allowed certain credits to reduce that tax amount. Under state law individuals generally are allowed a personal exemption credit, with an additional exemption credit allowed for seniors. The renter's credit is another credit that is claimed by many individuals, and a special head of household credit is available for certain qualifying seniors.

Nonresident and part-year residents -- These individuals must make additional calculations to compute their taxes for California income tax purposes.

The income tax is self-assessed. However, the department is required to determine that the correct amount of tax is reflected on the return. Additionally, FTB must capture income tax return data for statistical purposes.

THIS BILL

Under this bill, all qualifying taxpayers would have the option of using the Form 540 2EZ, as prepared by FTB, to file their income tax return. To qualify for this filing option, the taxpayer must be able to meet the following income thresholds:

- a single person with total income for the taxable year of \$50,000 or less; or
- a married couple filing a joint return with total income for the taxable year of \$100,000 or less.

For purposes of determining the income thresholds, "total income" would mean taxable wages, dividends, interest, and pension income.

IMPLEMENTATION CONSIDERATIONS

According to the author's office, the author intends for the income thresholds and certain of the current limitations (i.e., no federal/state adjustments to income, must be a resident) for the Form 540 2EZ to continue under this bill. However, taxpayers would not be precluded from using Form 540 2EZ merely because they:

- have income from social security, interest income in excess of \$400, dividends, or pension income; and
- are age 65 or older.

Although the language of this bill does not achieve the author's stated goals, this analysis assumes the bill would be amended to achieve the author's intent. Department staff is available to assist with amendments.

It should be noted however that legislation is not needed to require the department to create simple tax forms. Current state law allows the department to design forms that ease taxpayer compliance. Further, the Franchise Tax Board is committed to simplifying the ways Californians file their returns and pay their taxes. The department has an ongoing history of attempting to ease the administrative filing burdens on taxpayers and helping individuals file their tax returns faster and better. The department is constantly improving filing systems. For example, adding programs like Internet filing, electronic filing, Telefile, offering simpler paper returns like the Form 540 2EZ and Form 540A Senior, and providing a variety of scanning options. Department staff is available to explore ideas for simpler forms, new forms, and other methods of filing.

The Form 540 2EZ could be revised to meet the author's stated goals by:

1. adding lines on the form for nontaxable items such as social security. These lines allow the department to continue to readily determine that taxpayers correctly report income and compute their tax, and to capture all the statistical data currently required.
2. adding lines on the form for estimated payments and the California Senior Special Fund voluntary contribution.
3. adding special tax tables and instructions to accommodate the additional personal exemption credit allowed for seniors.

Department staff is uncertain if the changes required by this bill would require the form size to increase. The revised form might be able to maintain the post-card size, however it would have

smaller print and less white space than the current form. There would be 24 additional pages of tax tables and about four additional instruction pages. The booklet would increase from 32 pages to 60 pages.

Department staff is reviewing the impact of the changes required by this bill to the Telefile filing option.

LEGISLATIVE HISTORY

AB 2347 (Bates; 1999/2000) would have given qualifying seniors the option of computing their tax liability either using a flat tax method or using the current tax law method. *AB 2347* was not heard in its first policy committee (Assembly Revenue and Taxation Committee).

AB 305 (Strickland, 2001/2002) would give qualifying seniors the option of computing their tax liability either using a flat tax method or using the current tax law method. *AB 1370 (Wiggins, 2001/2002)* allows qualified seniors an option to file a certain income tax return form, similar to that under this bill. Both bills are in the Assembly Revenue and Taxation Committee.

OTHER STATES' INFORMATION

Review of *Michigan* and *New York* tax forms found that those states do provide a short and long personal income tax form. However, individuals with pension or social security income are required to file the long form. *Illinois*, *Massachusetts*, and *Minnesota* provide only one personal income tax form, which appears to be the equivalent of a California Form 540. The forms of these states were reviewed because their tax laws are similar to California's income tax laws.

FISCAL IMPACT

Departmental Costs

For budget year 2001–2002, department costs are estimated to be \$1.2 million with ongoing costs of \$1 million. The majority of these costs are attributable to the increased size of the Form 540 2EZ booklet. Approximately 5.2 personnel years will be needed to process the revised return.

ECONOMIC IMPACT

Tax Revenue Estimate

This bill would not impact personal income tax revenue. Those taxpayers who do not qualify to file the Form 540 2EZ would continue to file the existing income tax return forms.

ARGUMENTS/POLICY CONCERNS

This bill would allow about 270,000 more taxpayer to file the Form 540 2EZ. However, the form and tax tables would become more complex for the 3 million taxpayers who currently use the form.

This bill focuses on the filing of a paper return, which is in conflict with California's goal of using new technologies and the department's goal of paperless filing. Please see "Filing 2010 -- The Future of California State Income Tax Filing," available on the department's web site at www.ftb.ca.gov.

This will would require the department to revise Form 540 2EZ to allow the senior exemption credit. After this modification, the only exemption credit not allowed on Form 540 2EZ would be the exemption credit for the blind. Adding the exemption credit for the blind would add even more lines to the Form 540 2EZ and more tax tables to the instructions, further complicating the simplest tax form.

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